Citizens Finance Review Commission

Eliminate or Reduce the Business Personal Property Tax

Prepared for the Citizens Finance Review Commission

by

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The proposal:

Business personal property (BPP) taxes are imposed on the net assessed value of property (equipment) used for commercial, industrial, utility, mining or agricultural purposes. The business owner is required to file an annual Business Property Statement by April 1. The business owner reports the cost and type of personal property by year of acquisition for each business location. The County Assessor determines the depreciated or taxable value of locally assessed property (commercial, industrial & agriculture) based on the type of equipment, percent good tables prepared by the Arizona Department of Revenue (ADOR), and other statutory requirements. ADOR administers the BPP tax on centrally assessed properties (ex. utilities and mines). All BPP is normally subject to property tax, except for inventory held for resale and certain animals.

Under the Arizona Constitution and A.R.S. § 42-11127, the 2003 property tax exemption for locally assessed commercial and agricultural BPP is $55,465. This constitutional exemption was approved to reduce the property tax costs on small business and reduce administrative compliance costs.

Most states that impose a BPP tax, also provide for property tax abatements and incentives for targeted industries (ex. Manufacturers) and/or targeted areas (ex. Enterprise Zones).

Per a review of State tax laws, the following States have no BPP tax:

DE	Industrial machinery only
IA	
IL	
MA	Manufacturers only
MN	
NH	Machinery & equipment only
NJ	
NY	
PA	
SD	

The Legislature has the authority to enact laws to modify the existing property tax system, including creating new property tax classes, changing class assessment ratios, and adjusting taxable values for specific types of property. Legislative changes must be uniform and nondiscriminatory within each class of property. The Legislature doesn't have the authority to create a BPP tax exemption. Such a property tax exemption requires an amendment to the Constitution.

Per ADOR analysis of the 2002 property tax roll, BPP (both centrally and locally assessed) tax of $667M was collected in 2002. The estimated net assessed value on locally assessed personal property is $1,814,351,752. Using the state average tax rate of $8.56 for primary and $3.93 for secondary, the estimated property tax collected on locally assessed property is approximately $227M, or 5.1% of total property tax revenue collected in 2002.

Category	2002 Net Assessed Value	2002 Est Tax $ (before Homeowners rebate and 1% limitation)	% of total
Residential (Owner Occupied & Rental)	18,268,239,862	$2,246,741,666	51.1%
Business Real	7,780,613,892	$1,146,861,833	26.1%
Business Personal centrally assessed	3.611,394,545	$ 450,769,337	10.2%
Business Personal locally assessed	1,814,251,752	$ 226,612,534	5.1%
Other – difference		$ 329,014,630	7.5%
Total 2002 Property Tax Roll		$4,400,000,000	100.0%

Under the theory that state and local government will still need to collect the same amount of property tax revenue, an elimination or reduction in the BPP tax shifts the tax burden to the remaining property taxpayers (primarily homeowners and commercial real property owners). If BPP tax was eliminated on locally assessed personal property, existing tax rates would have to increase by 5% or more to maintain existing property tax revenue of $4.4 billion. A 5% plus increase in the primary tax rate, unless accompanied by a 5% increase in full cash value, will also cause more homeowners to exceed the 1% cap, necessitating higher costs to the state for the homeowners primary tax amounts that exceed the 1% cap. In addition, if school primary rates are adjusted upward to make up for the lost revenue, there will also be increased costs to the state general fund for the homeowner's rebate (currently 35% of class 3 primary school taxes).

The proposal before the CFRC is the elimination of the BPP tax on locally assessed personal property. This analysis excludes the impact from eliminating the BPP tax on centrally assessed personal property.

BPP Reduction Scenarios:

The proposal before the commission is the elimination or reduction in BPP tax on locally assessed personal property. This change could occur under numerous scenarios, and in combination with other property tax reform proposals before the commission. This discussion is limited to 3 alternatives, with static impact based on 2002 property tax roll data from ADOR and ATRA:

A. Reduce the BPP tax by gradually lowering the assessment ratio

B. Reduce BPP taxable values for targeted industries (ex. Manufacturers) through further changes in depreciation schedules

C. Income tax credit for 100% of BPP tax paid

Alternative A - Reduce the BPP tax by gradually lowering the assessment ratio:

Under the Constitution, the Legislature has the power to enact laws, but it doesn't have the authority to create a property tax exemption. A BPP exemption would require a constitutional amendment.

The Legislature has the authority to create and change assessment classifications and ratios. To gradually phase out of the BPP tax, the Legislature could use a number of different approaches, including lowering assessment ratios on BPP in specific industries and/or changing scheduled depreciation adjustments. However, targeting the relief to specific industries would likely require the creation of separate class of property for the targeted industries.

Further, a gradual phase out would minimize the impact on remaining taxpayers.

BPP tax collected on locally assessed personal property was $227M in 2002. A phase out at 20% per year would approximate:

Year	Phase out %	Estimated property tax $ shift to remaining taxpayers
1	20%	$45M
2	40%	$90M
3	60%	$136M
4	80%	$181M
5	99%	$225M

Too long of a phase out period may delay BPP investments until reductions take full effect.

Because this approach does not grant an outright exemption, the Legislature has the authority to enact this type of change. Prior to the constitutional amendment that granted an exemption for the first $50,000 in locally assessed personal property, the Legislature had dropped the assessment ratio on that property to 1%. The courts later confirmed the Legislature's authority to set an assessment ratio at 1%.

Alternative B – Reduce BPP taxable values for targeted industries (ex. Manufacturers) through further changes in depreciation schedules:

Under A.R.S. § 42-13352, the Assessor determines the taxable value of BPP for manufacturers, assemblers or fabricators by the appropriate depreciation prescribed by ADOR, and then adjusts the taxable value by the following percentages:

Depreciation Schedule Adjustments on BPP:	ARS 42-13352
1st yr of assessment	35% of depreciated value
2nd yr of assessment	51% of depreciated value
3rd yr of assessment	67% of depreciated value
4th yr of assessment	83% of depreciated value
5th & subsequent yrs of assessment	Use scheduled depreciated value

The Legislature has the authority to make further changes in the BPP depreciation schedules. For example, a 50% reduction in the above table results in the following proposed percentages:

Depreciation Schedule Adjustments on BPP:	Proposed 50% reduction
1st yr of assessment	17.5% of depreciated value
2nd yr of assessment	25.5% of depreciated value
3rd yr of assessment	33.5% of depreciated value
4th yr of assessment	41.5% of depreciated value
5th & subsequent yrs of assessment	Use scheduled depreciated value

This alternative would reduce the BPP taxable value for the targeted industries only, and minimize the impact on existing tax rates and the increased costs to the state for homeowner rebate and homeowner primary taxes exceeding the 1% limitation.

Alternative C – Income tax credit for 100% of BPP tax

The creation of an income tax credit would not simplify the property tax system, but would help preserve existing property tax values that impact various tax rates, levy limits, debt limits, etc. An income tax credit further limits the benefit to those businesses with an Arizona income tax liability. Depending on the carry forward provisions for unused credits, an unprofitable business, or a business with minimal Arizona income tax liability, may never realize the full benefit from an income tax credit for BPP tax.

Under Alternative C, the cost of the incentive would be borne exclusively by the State as opposed to all of the taxing jurisdictions that rely on property tax revenues. City and Towns do share in 15% of the state income tax and therefore would also be impacted to a small degree as a result of decreased income tax collections.

Prior legislative attempts to pass a BPP income tax credit have been unsuccessful. In addition to the cost to the state general fund and cities, there was also concern about the state accepting the liability for tax increases at the local level that the State exercises no control over.

How to administer this tax reform:

Systems and personnel are already in place at the County and State to administer and collect the BPP tax. The County Assessor determines BPP tax values based on returns filed by business owners. The County Treasurer prepares and collects BPP tax bills. ADOR determines business personal property tax values for centrally assessed properties (ex. utilities and mines) and prepares and collects BPP tax on centrally assessed taxpayers.

Impact of this tax reform on Existing Revenue Systems:
The BPP tax is primarily administered at the County & State level. Any changes should require minimal administrative cost. Again, to the extent state and local government will still collect the same amount of property tax revenue, a reduction in the BPP tax will result in a tax shift to other property taxpayers.

For some special taxing jurisdictions that have maximum rate caps (fire districts, flood districts, fire district assistance tax etc.) the decrease in value from the loss of BPP could potentially be a direct loss in revenue if the jurisdiction is at the rate cap. However, the Legislature could make adjustments to those maximum rate caps.

While difficult to quantify, the elimination or reduction in the BPP tax would have a positive economic impact, resulting in an increase in other types of tax revenues. The elimination of the BPP would make Arizona more attractive to capital intensive manufacturers with significant investments in BPP.

Cost to Administer proposal:

Because systems and personnel are already in place at the County and State to administer and collect the BPP tax, the cost to administer a change in the BPP tax should be minimal. Existing BPP systems can be adjusted for changes in assessment ratios or depreciation schedules. An elimination of the BPP tax reduces compliance costs for both the government and BPP taxpayers.

If the BPP tax is reduced, the impact on compliance costs for business owners is minimal, because businesses are already filing property tax returns. If the BPP tax is eliminated, compliance costs are reduced.

Policy Considerations:

<u>Equity</u>
Arizona's current property tax system applies varying assessment ratios to nine classifications of property. As has been repeatedly documented, this system results in large inequities in taxes between residential and business property. Arizona's commercial and industrial property taxes have been documented to be some of the highest in the country.

A reduction or elimination of the BPP tax on locally assessed personal property would improve equity between some business property taxpayers and residential taxpayers. However, because of the tax shift, those business property taxpayers with small amounts of BPP may actually see increases in their effective tax rates.

Economic Vitality
As already discussed, an elimination or reduction in the BPP tax should help promote economic development by encouraging investments and business expansion, thereby creating an increase in other types of tax revenue.

Volatility
The amount of BPP tax raised each year is moderately volatile. BPP tax depends upon the amount of capital investment. While elimination of the BPP would initially reduce the property tax base, the property base would become more stable in the future because there is less fluctuation in real property values.

Simplicity
An elimination of the BPP tax would simplify the system and reduce administrative costs for both government and business owners. A reduction in the BPP tax wouldn't simplify the system or reduce compliance costs.

Economic Impact:
A reduction in the BPP tax results in a property tax increase on the remaining property taxpayers. However, a lower BPP tax should help promote economic development by encouraging investments and business expansion, thereby creating an increase in other types of tax revenue.